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STATE FOR EAP/MLS AND EB
TREASURY FOR OAISA
COMMERCE FOR EAP/MAC/OKSA
STATE PASS USTR FOR BARBARA WEISEL, DAVID BISBEE
FEDERAL RESERVE SAN FRANCISCO FOR DAN FINEMAN
SINGAPORE FOR FINATT BAKER

E.O. 12958: N/A
TAGS: EFIN ETRD EINV ECON TH
SUBJECT: THAI STOCKS SUFFER SUBPRIME FALLOUT, BUT DIRECT
BANK EXPOSURE MINIMAL

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¶1. Summary. Thai banks do not have significant direct exposure to the collapse of the U.S. subprime mortgage market and associated debt instruments. So far, only one bank, BankThai, has reported significant holdings of collateralized debt obligations (CDOs) derived from subprime mortgages, with an exposure of about USD 50 million. However, the indirect impact of tight credit worldwide has caused a sharp selloff of Thai stocks in line with other regional equity markets, with the Thai Stock Exchange falling over 3 percent on August 16 alone and 15 percent since July 26. The stock market impact has temporarily relieved upward pressure on the Thai baht, which had risen over 18 percent against the dollar this year through July. RTG finance officials have issued mild statements saying they are monitoring capital flows, but observed that the stock drop resulted from a worldwide credit squeeze and is not a reflection of direct Thai exposure to subprime lending. The Thai central bank has faced criticism throughout the year from exporting companies negatively impacted by the baht's appreciation. With most observers now expecting the baht to stabilize or slightly weaken over the next two months, pressure for exchange rate intervention will likely tail off. End Summary.

Minimal Direct Exposure to Subprime

¶2. Thai finance officials and private sector analysts report that Thai banks have minimal direct exposure to the subprime mortgage market in the U.S., including mortgage-backed securities or derivative collateralized debt obligations (CDOs). The worst-affected bank is BankThai with approximately USD 50 million invested in mortgage-backed CDOs (out of a total CDO portfolio of USD 420 million). BankThai had already set aside USD 8 million in the first half of this year to cover possible losses on this portfolio. Three other Thai banks have significant exposure to offshore CDOs (Krung Thai at USD 160 million, Bank of Ayudhya at USD 80 million, and Bangkok Bank at USD 50 million), but stress that these investments are not based on subprime mortgage assets. The Thai bank with the highest foreign bond investment portfolio,

Kasikorn Bank, reports that about a third of its overall investment portfolio is in foreign government bonds and top-grade corporate bonds, with no exposure to subprime CDOs. All told, Thai bank holdings of foreign assets represent about 9 percent of total bank investments of USD 29 billion.

Fallout Hits Thai Stocks, Relieves Upward Baht Pressure
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¶3. The Stock Exchange of Thailand (SET), however, has been roiled by the global stock selloff, falling over 15 percent since July 26, and over 3 percent on August 16 alone. The SET's drop in share prices has been the third-largest fall in Southeast Asian stock markets, behind only the Indonesian and Philippines exchanges. Bank of Thailand (BOT) Governor Tarisa Watanagase issued mild comments on August 16 saying she was closely monitoring capital flows, with foreign investors having sold nearly USD 1 billion in Thai shares since the last week of July. She said that the BOT did not need to inject liquidity into the banking system due to the minimal exposure of Thai banks to subprime securities, and stressed that she would not introduce any measures to ameliorate the stock sales or their impact on the Thai baht.

A Temporary Respite in Baht Debate

¶4. The recent weakening of the baht (now quoted at Bt.34.5/USD) has temporarily shifted attention away from its year-long appreciation. The baht reached a 10-year high in July at Bt.33.3/USD after rising 18 percent in 2007. Although Thailand's export revenue has continued to grow strongly, analysts have forecast a sales slowdown in the second half of the year as the price of Thai goods becomes relatively more expensive overseas. A number of low-cost, labor-intensive textiles factories have already announced their closure in the past two months due to slowing orders.

One plant's plans to lay off 6,000 workers were met with massive protests in a Bangkok suburb in July, with rival politicians accusing the government of neglecting its export industry workers by allowing the baht's rise. Another two footwear factories, with combined employment of 4,300, announced their closures in August.

¶5. The debate on the future of the baht has divided local economists and business leaders into two camps. One side, which includes former Finance Minister Pridiyathorn Devakula, has urged the RTG to target an "appropriate" exchange rate of around Bt.34.5/USD to maintain export competitiveness and prevent foreign investors from speculating in the currency. Pridiyathorn resigned in February after heavy criticism of his aborted effort to halt the baht's rise through capital controls last December. He urged the BOT yesterday to continue the one remaining provision of those controls, a 30 percent reserve requirement on capital inflows, to guard against a possible resurgence of portfolio investment from investors fleeing shaky markets in the U.S. and Europe. (Most pundits, however, believe a quick rebound in stock prices in unlikely until the global subprime fallout settles.) "We should allow investors to profit only from the stock exchange and not in changes of the baht, or else the currency will continue to swing sharply," he said.

¶6. Other analysts are skeptical (correctly, in our view) of the BOT's ability to control long-term trends in the baht in light of continuing large current and capital account surpluses. Prime Minister Surayud Chulanont himself said on August 11, "We can't really say that the baht won't hit Bt.30/USD, because we're not aiming for any target - stability simply means that the rate mustn't change abruptly and rapidly in a short period." A prominent economist told Econoff this week, "We can't stop fundamental changes in global trade and investment trends - we're facing the opposite problem of 1997, when our foreign reserves ran dry."

"Back then," he added, "we needed exports to generate foreign exchange and pay off our debts to the IMF. Today, we have a maturing economy, with the strong baht a reflection of our recovery from 1997. We should embrace our new purchasing power and prod our export-focused industries to adjust their production to the domestic market."

¶7. Asked where current Finance Minister Chalongphob Sussangkarn stood on this, the economist replied, "He just wants to get to December (for the projected elections) and hand this off to the next government - a temporary weakening of the baht due to the subprime-induced stock selloff will only help him." Another private sector economist, who advises the Ministry of Finance on monetary policy, said, "We've got three choices: 1) leave the exchange rate alone and force uncompetitive companies to adjust from the export market to the domestic market; 2) strongly intervene in currency markets to keep the baht level and satisfy exporters; and 3) drive the baht down by drastically reducing interest rates to boost liquidity." The likely outcome? "For an economist, the first choice is preferred and the second is not feasible - the third is the most likely, but it won't happen during Chalongphob's time because he's worried about inflation - wait for the next government and see what happens."

¶8. Comment: Most advocates of a more targeted exchange rate, including Pridiyathorn, have placed a "preferred value" on the baht of somewhere between Bt.34 to 35/USD, which is where it stands now (although some exporting industry representatives have called for a Bt.36/USD rate.) Analysts have also noted that the gap between the onshore and offshore baht rates has narrowed to 2.5 baht (31.55 to the dollar offshore buy rate compared to 34.06 onshore) from a nearly 4 baht difference last week. This reflects the BOT's approval of 25 billion baht in local borrowing by foreign investors to bring offshore hedging contracts to the onshore market (the BOT now allows foreigners to hedge baht-denominated transactions with local institutions without being subject to the 30 percent reserve requirement.)

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